demand volumes may not be enough to fill equivalent capacities. Since the cost to transport a given unit of capacity (*e.g.* a megabyte) decreases as higher capacity OC systems are used, we would expect to observe the cost per mile of transporting DS3 capacity on the Manhattan-Los Angeles route to be less than the cost to transport DS3 capacity on the Poughkeepsie route.[37] Note that what drives the difference in price per mile in this example is not distance *per se*, or the number of competitors on a given route. Rather, what determines the cost per mile is the density of demand on the route, *i.e.*, the fact that for all carriers, demand is likely to be greater on long-haul routes, permitting the use of higher capacity (and lower cost) transport.

37. Several differences in the typical long-haul and short-haul transport networks contribute to lower costs on long-haul routes. First, the architecture and facilities are different. These include, on long-haul routes, a more intensive use of Dense Wavelength Division Multiplexing with a much higher average number of wavelengths, a smaller proportion of multiple rings, a more intensive use of higher transport speeds, and a higher average number of miles per ring. Second, fiber deployment costs on long-haul routes (using, for example, aerial cable and railroad rights-of-way) will be lower per mile than on urban short-haul routes, which require a higher proportion of dug-up streets and buried cable. Third, the long-haul prices may be depressed because of the current glut of long-haul capacity.

38. Consider the airlines. On coast-to-coast or overseas flights, the airlines pack hundreds of us into Boeing 747s, whose cost per seat mile is considerably less than the cost per seat mile of the Embraer that flies between Boston and Albany. The fact that Boston-Albany prices are much higher per mile than Boston-San Francisco prices is not due entirely (or even primarily) to differences in competition between the routes but rather to differences in the technologies (and costs) that the different densities of demand on the routes make possible. As one industry study found:

> How much of the variation in fares among hub routes is explained by differences in competition and costs? According to our estimates, differences in load factor account for about half of the observed differences in fares for small and nonhub routes relative to large hub routes. Differences in aircraft size account for about

[37] For example, the bit rate (Mbps) of an OC-12 is 622.080, four times the bit rate of OC-3 even though the price of OC-12 is generally not four times the price of an OC-3.

40 percent of the difference. The relative lack of competition at small and nonhub airports accounts for only about 10 percent of the cost differences.[38]

39. To illustrate this point, I obtained the lowest non-stop round trip price, leaving Boston on July 29 and returning on August 8, 2005 from Expedia for 10 relatively high-density routes.[39] Using Dr. Wilkie's assumptions, I then regressed price per mile on the reciprocal of miles and a constant; the Excel regression output is shown in Taylor Attachment 1. Using these estimated coefficients, I forecasted the price of a round-trip ticket on 10 short-haul routes and compared those prices with the lowest actual prices for those routes on Expedia. The percentage differences between the actual short-haul round trip price and the "benchmark" short-haul price are shown in Figure 2. Thus, the actual prices for all short-haul Boston routes are higher than the benchmark prices determined using Dr. Wilkie's method, generally by between 40 and 60 percent, but by as much as 100 percent for the Boston-Albany route. By Dr. Wilkie's standard, then, "[t]his methodology ... provides clear and compelling evidence that [airline] prices are supra-competitive. In the absence of competition, [airline] prices should be regulated to prevent supra-competitive pricing."[40]

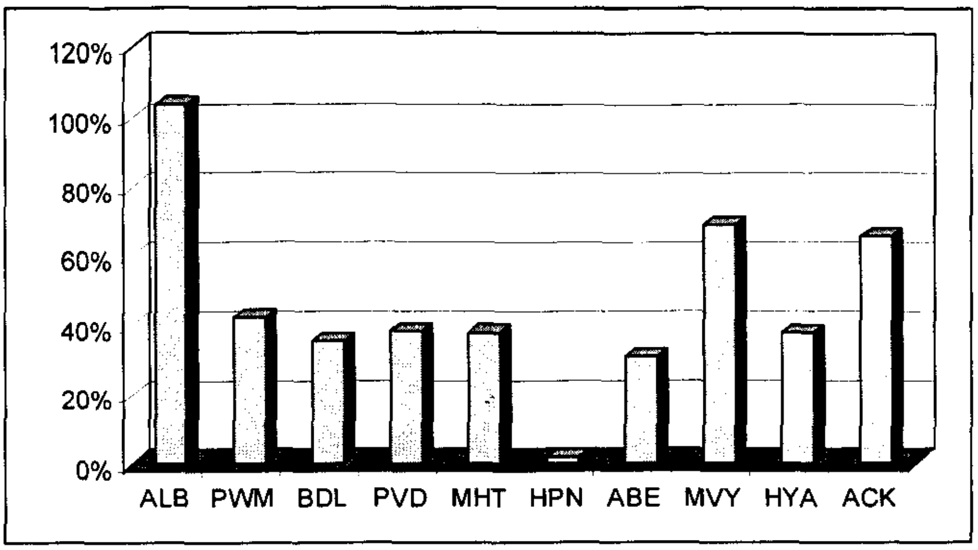
[38] S.A. Morrison and C. Winston, "The Fare Skies: Air Transportation and Middle America," The Brookings Review, fall 1997 Vol.15 No.4, pp. 42-45.

[39] The ten routes were Boston to and from San Francisco, Los Angeles, Chicago, Denver, San Diego, Seattle, Las Vegas, Atlanta, Miami and Dallas.

[40] Paraphrase of Wilkie Declaration at ¶18.

Figure 2

Comparison of Benchmark and Actual Prices
for 10 Short-Haul Boston Routes



Source: Expedia, accessed July 20, 2005. Airport codes (left to right) are Albany, Portland (Maine), Bradley (Hartford), Providence, Manchester (New Hampshire), Westchester County (New York), Allentown (Pennsylvania), Martha's Vineyard, Hyannis (Massachusetts), and Nantucket.

40. On the contrary, this method incorrectly assumes that the only determinant of airline [or DS3 transport] price per mile is distance. In Dr. Wilkie's model, the price of each DS3 point-to-point connection is assumed not to depend on the type of transport system actually used to provision the customer's DS3 level transport. Because the long-haul contracts that Dr. Wilke uses to establish a competitive benchmark are more likely to be multiplexed and carried on higher bandwidth systems than short-haul special access circuits, Dr. Wilkie's comparison is biased, just as the assumption that the technology and costs of short-haul, low-density airline routes are the same as on long-haul, high-density routes. Some portion of what he asserts to be supra-competitive special access prices for a 10 mile circuit is actually the result of lower costs stemming from the higher bandwidth transport that is possible on the longer-haul routes.

41. A second basic error in this approach is the assumption that incremental costs determine prices in a similar fashion for long-haul and short-haul transport. Prices in effectively competitive telecommunications markets are not determined solely by cost; demand conditions matter as well, for industries having a high proportion of fixed costs, because prices must be

marked up above incremental cost for services in order to recover the total cost of the firm.[41] Since the volume of demand for POP-to-POP transport between Boston and San Francisco is an order of magnitude greater than the transport demand between ILEC wire centers in Boston and Framingham, it would not be surprising to see different mark-ups of price over incremental cost on those routes. Supply conditions other than cost matter as well – for example, the current glut of long-haul capacity. Thus, even if the cost per mile of transport on long-haul dense routes were the same as on short-haul sparse routes, it would not follow that the prices per mile for those services would be the same, assuming both services to be provided in effectively competitive markets.

42. In short, Dr. Wilkie assumes that the relationship between price per mile and miles for 100 – 3000 mile routes would be the same for 10 mile routes if competitive conditions were the same. That is, any deviation in the price per mile of 10 mile circuits from the relationship fit to data from 100 – 3000 mile circuits is assumed to be caused by the less competitive conditions under which 10 mile special access transport is allegedly sold. But as discussed above, we would not expect this to be the case because the price per mile for shorter-haul routes, *holding constant the level of competition*, should be higher than the price per mile for longer-haul routes because of (i) the technology (and costs) embodied in the underlying transport routes and (ii) the higher volumes of demand on longer-haul routes. Therefore, one cannot properly use his model estimated from longer-haul routes to predict competitive market prices on shorter-haul routes.

3. The method ignores the fact that special access customers receive deep discounts off the tariffed prices

43. Dr. Wilkie compares forecasted competitive market prices with 36 month term discount tariff rates, which embody a 10 percent discount off of the month-to-month rate. However, these are not the best rates that ILEC customers actually pay. As discussed in Verizon's Comments,[42] competitive forces compel Verizon to offer special access tariff discounts of up to 40% off the standard month-to-month rates and individually negotiated contract tariffs with discounts up to 70% off the month-to-month rates. Moreover, most ILEC special access is sold at such

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[41] See J.A. Hausman, "Regulated costs and prices in telecommunications," in G. Madden and S. Savage (eds.), The International Handbook of Telecommunications Economics, Vol. II, Edward Elgar (2000), Chapter 12.

[42] Verizon Comments at 3.

discounts. When this fact is taken into account, the difference between Verizon's ten mile DS3 interoffice transport price and a ten mile "competitive" long-haul price diminishes significantly. For example, discounts in the 40 to 70 percent range mean that the actual prices that Verizon's customers pay for DS3 interoffice transport can range from $606 to $1,211 for a ten mile route.

4. The statistical analysis and reporting does not support the conclusions

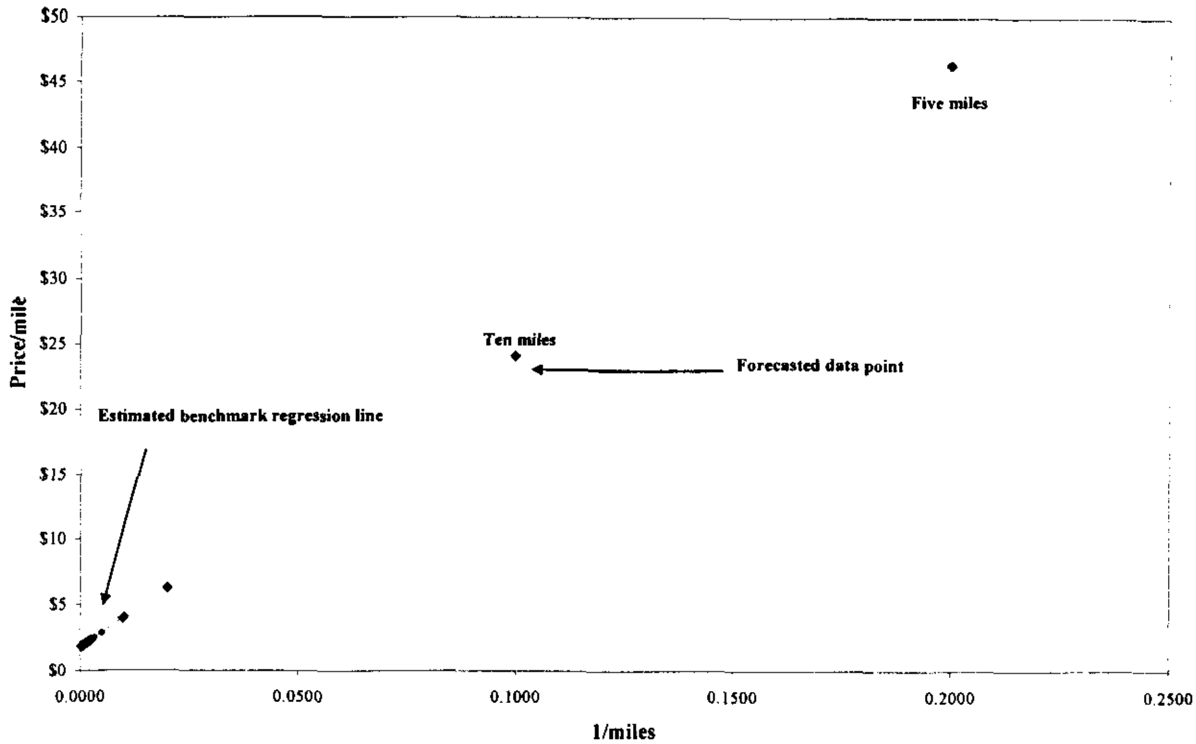
44. Dr. Wilkie's statistical analysis is flawed and cannot be used to assess the competitiveness of the special access market. First, in his discussion of the statistical work that he performed, Dr. Wilkie provides scant information about his model, providing the reader only with the point estimates for the distance variable and the constant term. No information is provided to permit the reader to assess the statistical performance or robustness of the model. Most importantly, the critical calculation from which his policy conclusion derives is a forecast of price per mile for 10 mile circuits, and Dr. Wilkie does not report a forecast interval or provide enough information for us to calculate what that interval might be.[43] As his forecast is made far from the mean of his (single) independent variable, one would expect, *a priori* that the forecast interval would be large.[44] See Figure 3.

[43] A forecast interval is a confidence interval around the point estimate of the forecast with the following interpretation for a 95% confidence interval. Suppose the assumptions of the model were correct, and the regression was run on 100 independent data sets. Then the true (but unknown) value of the competitive price of a 10-mile circuit would lie outside the 100 calculated forecast intervals no more than 5 times.

[44] The formula for the forecast interval shows that its length is approximately proportional to the absolute value of the difference between the value of the explanatory variable (here, 1 / 10 miles) whose price per mile is being forecast and the average value of 1 / miles in the sample. See, e.g., W. Greene, Econometric Analysis, Fifth Edition, Prentice-Hall (2003), at 111.

Figure 3

The Predicted Data Point is Far from the Sample Observations



45. Second, the statistical admonition to not forecast far from the data is particularly pertinent here because Dr. Wilkie has imposed an extremely restrictive functional form on the data, relating price per mile linearly to the inverse of mileage. Specifically:

$$y = \beta_0 + \beta_1 d^{-1}$$

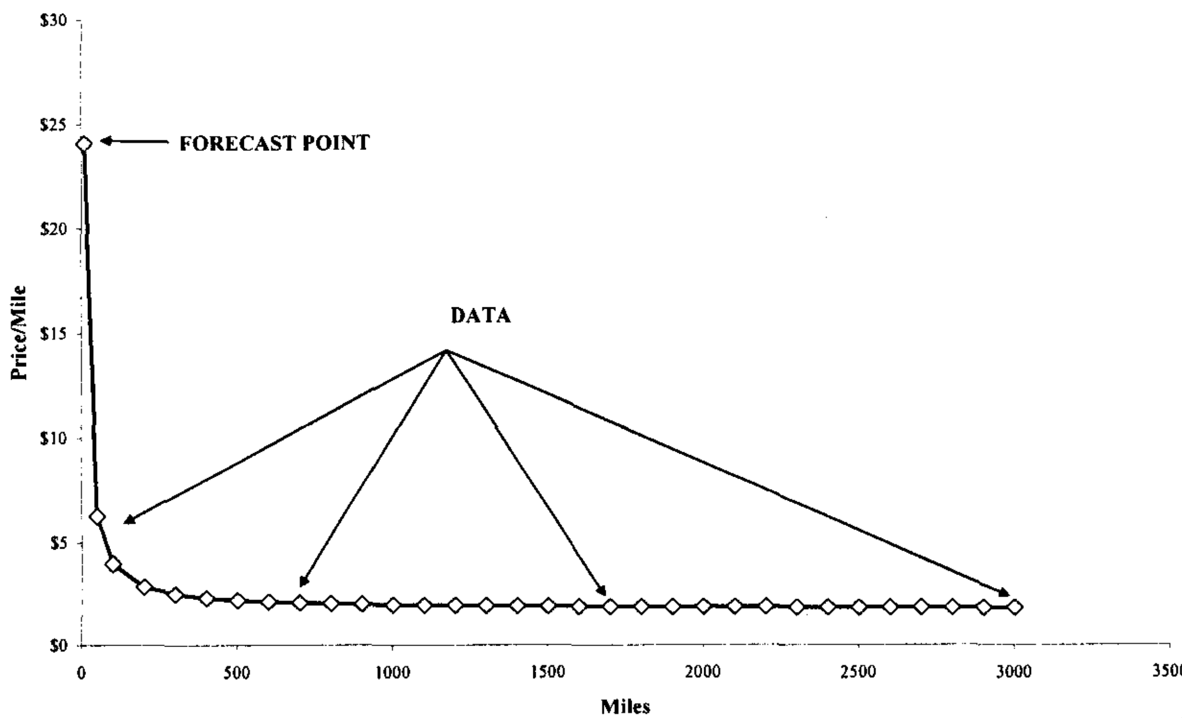
where y is equal to long-haul capacity prices per mile, d is distance in miles, β_0 is the constant term and β_1 is a coefficient. This is the formula for a hyperbole, so that price per mile and mileage are constrained to lie on a curve of this particular shape. While such a relationship may seem plausible, standard procedure would be to allow the data to choose precisely how price per mile varies with mileage and to include Dr. Wilkie's simple linear form as a nested model in a more general specification.

46. Use of this restrictive specification is a serious error in Dr. Wilkie's analysis because he uses the model and its very restrictive functional form to forecast prices per mile for distances far

outside those in the sample he used to estimate the parameters of the model. As the relationship between y and d is a hyperbole, Dr. Wilkie forecasts the values of y for small distances from a scatter of data points for large d. Thus, the only thing that tells us how price per mile varies with mileage for small mileage is Dr. Wilkie's *assumption* about the functional form. See Figure 4.

Figure 4

The Assumed Functional Form Largely Determines the Forecast



47. Apart from possible problems with the functional form, Dr. Wilkie's model is mis-specified, as discussed above, because it omits a variable (technology) that affects transport prices and varies systematically with mileage. In his model the price of each DS3 point-to-point connection does not depend on the type of transport system (whether DS3 or higher) that is actually used to provision the transport. His model relates prices only to distance, and so any two point-to-point routes of identical distance would, based on his model, have the same price

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per mile. In fact, this is not likely to be the case. A 200-mile transport route that is multiplexed with other customer's circuits and provisioned on an OC-192 system will be able to provide DS3 capacity at a lower cost than on an alternative 200-mile transport route that is provisioned on an OC-12 system. And in competitive markets we would expect that these cost differences would give rise to differences in prices.

IV. The Commission's Rules Should be Modified to Recognize the Role That Market Forces Play in the Provision of Special Access Services

A. Pricing Flexibility Triggers

48. Several parties criticize the economic logic underlying the Commission's original choice of pricing flexibility triggers. For example, Uri-Zimmerman argue that the collocation trigger is deficient because it does not measure the *degree* to which collocators compete.[45] However, measuring the degree of current competition — *e.g.*, the number and size of competitors currently providing service in the market — is not an economically satisfactory method for determining when a service need no longer be price-regulated. The process of litigating market power studies is interminable and, at the end, provides no bright-line standards on which the regulators and the industry can rely. In addition, a focus on current competitors and competition is inherently backward-looking where the point of the exercise is to determine whether market forces can discipline prices going forward. The point of the Commission's Pricing Flexibility decision was to use a readily observable trigger instead of market power studies to determine when price regulation was no longer necessary. Collocation made economic sense as a trigger because, (i) it is observable and (ii) unlike current market concentration measures, collocation signals the absence of important barriers to entry and expansion, which are key forward-looking determinants of the competitiveness of a market and whether market forces are better suited to protect customers than regulation.

49. Because a collocated firm has incurred the fixed costs of entry, expansion is relatively cheap if price is raised above the competitive level. The fact that a collocated carrier serves one customer rather than 1,000 does not mean that that carrier exerts less competitive pressure. On the contrary, since the fixed and sunk costs for that carrier have already been incurred and

[45] Uri-Zimmerman at 169, emphasis supplied. Cited by Time Warner at p. 5.

subsequent expansion can be done at a comparatively low cost, such a carrier exerts the same competitive pressure as a carrier serving 1,000 customers. In addition, the presence of such carriers demonstrates to new entrants that collocation is feasible and economic.

50. Finally, as discussed in the Lew Declaration (at 464-48), a collocation-based trigger is "woefully underinclusive" because it ignores the presence of non-collocated competitors. Even if such information were to be included in the triggers, (as it should be), the measure would likely still be under-inclusive because ILECs have limited information on the scope of competitors' networks, and competitors generally have little obligation or incentive to provide the information.

B. Alternatives to Regulated Prices

51. One of the few proposals for ILEC special access pricing flexibility which several parties articulated and with which no party stated a disagreement was to permit price reductions through responses to RFPs and commercially-negotiated contracts ubiquitously, irrespective of collocation or other competitive showings.[46] In the original pricing flexibility order, the Commission reasoned that granting downward pricing flexibility before competitors had made irreversible investments in an MSA could exclude entrants from those markets:

> we consider forms of regulatory relief which, if granted prematurely, might enable price cap LECs to (1) *exclude new entrants from their markets*, or (2) increase rates to unreasonable levels. Accordingly, as a condition for granting further pricing flexibility, we require incumbent LECs to show that markets are sufficiently competitive both to warrant pricing flexibility to enable incumbent LECs to respond to competition and to discourage incumbents from either excluding new entrants or raising rates to unreasonable levels. In other words, we adopt requirements that price cap LECs make "competitive showings," or satisfy "triggers," to demonstrate that market conditions in a particular area warrant the relief at issue.
>
> The pricing flexibility framework we adopt consists of two phases. To obtain Phase I regulatory relief, the incumbent must show that competitors have made irreversible investments in the facilities needed to provide the services at issue, *thus discouraging incumbent LECs from successfully pursuing exclusionary strategies*. Phase I permits LECs to offer contract tariffs and volume and term

[46] Parties otherwise critical of RBOC special access pricing flexibility that affirmatively recommended ubiquitous downward pricing flexibility include Ad Hoc (Comments at p. 50) and CompTel/ALTS at 31.

> discounts, while requiring them to maintain their generally available price cap-constrained tariffed rates, thus protecting those customers that lack competitive alternatives.[47]

52. However, from an economic perspective, the distinction between price reductions to "exclude new entrants from their markets" and price reductions to compete with new entrants is a distinction without a difference. Provided the prices in question are not anticompetitive — *i.e.*, equal or exceed forward-looking incremental cost and are not unduly discriminatory — customers and the competitive process all benefit when all carriers can respond to RFPs and negotiate individual commercial contracts with customers. No customers are harmed when an ILEC responds to an RFP with lower negotiated prices because (i) customers will only buy an alternative plan if they prefer it to the regulated alternatives, (ii) other tariffed services remain available at unchanged prices, and (iii) under price caps, the ILEC gains no additional ability to raise other prices when it negotiates a lower-priced contract for a customer.

53. But what if the prices in question were anticompetitive? The Commission's concern — which was manifested in the Phase I pricing flexibility rules — was clearly to prevent the ILEC from engaging in anticompetitive pricing or other exclusionary strategies. The Commission's logic was simple. Once a competitor has entered and incurred sunk costs in a market, actions to exclude competitors would be an even less profitable strategy for the ILEC than before, because even if the entrant could be excluded from the market, the sunk assets would remain behind for another competitor to use. While this argument is correct as far as it goes, current economic thinking would not limit price reductions through RFP responses or commercial negotiations until the presence of competitors' sunk costs made anticompetitive pricing less profitable. Economic theory generally downplays the potential profitability of exclusionary pricing in the first place, and, where anticompetitive pricing is possible, there are safeguards in antitrust and regulatory economics — *e.g.*, incremental cost-based tests for predatory pricing or cross-subsidization — that can be used to prevent such behavior. What is never used as a safeguard are restrictions on the ability of the regulated firm to lower prices in competitive situations because such restrictions would eviscerate the emerging price competition that produces consumer welfare gains in the first place.

[47] Access Charge Reform, CC Docket Nos. 96-262, 94-1, 98-63, 98-157, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221 (1999) (Pricing Flexibility

54. In effect, requiring that competitors sink costs before the incumbent can respond similarly to competitive opportunities is a form of infant industry protection. While the policy is an improvement on traditional infant industry regulations in that it does go away automatically when the collocation triggers are satisfied, it nonetheless exhibits some of the other drawbacks associated with industry protectionism. In particular, it protects competitors rather than competition, and, in fact, diminishes the vigor of price competition to ensure that current competitors are not harmed by anticompetitive pricing. Such restrictions are particularly harmful for special access services, which are sold to customers having many different locations, so that MSA-based regulatory restrictions make it comparatively more difficult for ILECs to respond to RFPs or negotiate commercial contracts than for their competitors.

55. These rules also "protect" *all* competitors, infants and grownups alike. In the current state of play in communications markets where incumbent cable companies and incumbent wireless companies compete against the incumbent wireline telephone company and its wireline competitors, customers are not made better off by restricting the ability of the wireline incumbent to compete against other incumbent platforms to prevent anticompetitive harm to new wireline entrants.

C. Where Price Cap Regulation Remains, It Must be Simplified

56. No data is presented in the comments to support various parties' requests to contort price cap regulation to competitively advantage their services relative to those of the ILECs. As a result, the Commission has essentially no new evidence from which to conclude that the price cap status quo is somehow deficient and must be repaired. On the other hand, the presence of vigorous competition in these markets implies that what residual price regulation remains must be as competitively neutral as possible: the purpose of such regulation is to restrain potential exercise of market power, not to give particular competitors, technologies or platforms a regulatory advantage to enable them to compete successfully against the ILEC.

1. The rate structure must be simplified.

57. To that end, the fewer restrictions imposed on the ILECs' rate *structure*, the better. As demand, costs, technology and competitive conditions shift, carriers will find it profitable to raise

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Order) at ¶¶68-69 (footnote omitted, emphasis supplied).

some prices, lower others, and offer new discount plans and packages. Restrictive rate structures such as those proposed by ATX *et. al.* (at 29-30) constrain the types of services and packages the ILEC can offer and result in a menu of rates that is different from what their customers would prefer. For example, changes in cost or demand or competitive conditions can change the optimal relative markups (of price over incremental cost) for channel terminations and channel mileage. Unregulated carriers adjust their prices to respond to these changed conditions; if terminations and mileage were assigned to different baskets, the ILEC would be unable match its competitors (assumed) rate structure. As long as all prices at least cover total service long run incremental cost, there can be no argument that such prices constitute predatory pricing or cross-subsidization (as alleged by ATX *et. al.* at pp. 29-30). On the contrary, such prices *benefit* customers by moving towards their preferred rate structure.

58. ATX *et. al.* (at 30-32) urges the Commission to place DS1 end user channel terminations, POP channel terminations, channel mileage and other DS1 services in separate categories with a similar distinct basket with categories for DS3 services. Nextel (at 21) asks that end user and POP channel terminations be placed in separate categories. The problem with setting up these restrictive rate structures is that services are not sold this way. Enterprise and carrier customers do not shop for individual DS1 channel terminations and channel mileage circuits; rather, these services are bought as part of a network package — often custom designed — and regulatory constraints on the pricing of individual rate elements make it difficult for ILECs to put together responses to RFPs or to negotiate price reductions. As a result, adopting a restrictive rate structure not only competitively disadvantages a large supplier of wireline special access services, but it also may slow the rate at which ILEC average revenue per circuit can fall in response to competitive conditions.

2. The current value of the productivity offset is appropriate going forward.

59. No new productivity evidence is offered in the comments. ATX *et. al.* complains (at 25) that the current value of the X-factor is zero and that no efficiency gains are passed through to customers in the form of lower rates. Those claims reflect a fundamental misunderstanding of the economics of the price cap plan. First, under the CALLS plan, the X-factor is set equal to the rate of inflation (as measured by the Gross Domestic Product Price Index), not zero. The effect of setting X equal to GDP-PI is that the annual change in the price cap index — given by GDP-

$PI - X$ — is zero, not that X is zero. The price cap index is thus capped, and if actual prices were at the cap, those prices could not increase in nominal terms. Of course, the real value (relative to inflation) of those prices would be falling each year with inflation, at between 2 and 3 percent in recent years. Therefore, the productivity growth that the current value of X passes through to customers in prices is given by the annual rate of inflation.

60. As I showed in historical studies performed for previous FCC considerations of the value of X,[48] values in the 2 – 3 percent range emerge using both direct TFP methods and the indirect method based on historical prices. Since those studies were conducted, the industry collapsed, ILEC local exchange volumes and wireline long distance volumes fell for the first time in history and intermodal demand growth (from wireless and broadband) became a competitive force in the industry. The net result is that an updated wireline TFP study would be unlikely to show higher productivity growth than in the past.

61. PAETEC (at 17) claims that annual reductions in the price cap index are necessary because of the economies of scale that cause ILEC costs to fall. It proposes to set the productivity offset at a level that would just maintain the initial authorized accounting rate of return. However, what PAETEC describes is rate of return regulation on steroids. Ordinary rate of return regulation had a regulatory lag built in, so that the regulated firm could expect to earn above its authorized level for some (uncertain) period (until the regulator served a show-cause order) if it were more efficient than anticipated or to earn below that level if it became inefficient.[49] The PAETEC proposal would set rates to achieve an authorized rate of return over a future test period, which is precisely how rate of return regulation operated in theory. Worse, however, PAETEC proposes (at 18-19) to require earnings sharing if accounting earnings should exceed the authorized level, eviscerating the rudimentary efficiency incentives that traditional rate of return regulation built in through regulatory lag. While economists may disagree as to the degree of competition in special access markets, it would be difficult to find one that thinks that industry performance would be enhanced by reversing a fifteen year transition away from traditional rate of return regulation.

[48] See, e.g., "Economic Performance of the LEC Price Cap Plan," filed as Attachment 5 to the United States Telephone Association Comments, (CC Docket No. 94-1), May 9, 1994.

3. *The g-factor is irrelevant for special access services.*

62. I explained in my initial declaration that the g-factor in the common line basket was associated with the fact that the regulated rate structure recovered non-traffic sensitive costs on a per-minute basis, so that unanticipated growth in demand would result in an over-recovery of this component of non-traffic sensitive costs. That feature of the rate structure does not apply to special access services, and a productivity offset that reflects the relative productivity growth of the industry requires no adjustment to account for demand growth. PAETEC correctly observes that *if* a g-factor were used, care should be taken to avoid double counting TFP growth associated with demand growth embodied in X. In fact, if X is calculated correctly, the effect of demand growth on TFP growth is included in the value of X, and no additional factor should be added or subtracted from the annual change in the price cap index. Ionary recites evidence that special access demand has grown and asserts that special access costs have grown more slowly than demand due to economies of scale. From these claims, Ionary asserts that a g-factor is necessary in the price cap formula. However, Ionary does not consider how the productivity offset X is set in the first place and does not allow for the fact that calculations of X include the effects of demand growth and economies of scale on growth in total factor productivity.

4. Earnings sharing perpetuates an outmoded rate of return regulatory system.

63. PAETEC (at 18-19) and ATX *et. al.* (at 26) urge the Commission to reinstate an earnings sharing regime. As all parties recognize, the Commission determined almost a decade ago that the efficiency losses from sharing outweighed any benefit from keeping regulated prices closer to accounting costs:

> [S]haring severely blunts the efficiency incentives of price cap regulation by reducing the rewards of LEC efforts and decisions. These reduced incentives, we argued, can be expected to generate lower LEC efficiency, which in turn would reduce the benefits of price caps to consumers.[50]

Nothing in the data reported in these comments suggests that this conclusion should be reversed.

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[49] That expectation provided rudimentary incentives to expand productivity growth, which were later enhanced by the adoption of price cap regulation.

[50] FCC, In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Fourth Report and Order, 1997, ¶148.

64. On the contrary, this proposal to re-impose sharing in order to reduce earnings to an authorized level would undo the regulatory sea-change that this Commission instituted nearly fifteen years ago. If increased earnings or earnings in excess of an authorized level come to be interpreted as a failure of price cap regulation, then price cap regulation will become little more than rate of return regulation in disguise. The inference that prescriptive regulation (i.e., re-imposition of sharing or a higher value of X) is warranted because of high or increasing accounting earnings is inimical to the incentives intended under price cap regulation. Each ILEC's management must be able to face their accountants at the end of a successful month without fear that increased reported earnings will trigger regulatory retaliation. Otherwise, price cap regulation will be no better than rate of return regulation with an institutionalized time lag.

5. Interim Relief

65. Some parties urge the Commission to re-initialize special access rates to reflect an authorized rate of return.[51] Since there is no economic basis for concluding that special access rates are excessive, there is no economic basis to even consider interim relief. Moreover, from an economic standpoint, any such re-initialization would be detrimental to the performance of the industry. When the parameters of a price cap plan are altered (either during the course of the plan or afterwards) because the regulated firms were too successful, the damage to future productivity performance is likely to be significant.[52] The economic literature has coined the term "ratchet effect" to describe the losses in economic welfare that likely arise when an incentive scheme is updated in a mechanistic way by taking into account past performance.[53] If regulated firms believe that superior performance during the life of the plan will be used in setting the target during the next period, the firm's incentive to maximize technical and dynamic

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[51] PAETEC at 17; Nextel at 21.

[52] See D.E.M. Sappington, "Strategic Firm Behavior Under a Dynamic Regulatory Adjustment Process" Bell Journal of Economics, Vol. 11, No. 1, (1980) pp. 360-372. which shows how a regulatory mechanism (the Vogelsang-Finsinger mechanism), which resets prices periodically to match realized costs, can induce inefficient behavior on the part of the regulated firm.

[53] See Martin L. Weitzman, "The Ratchet Principle and Performance Incentives" 11 Bell Journal of Economics, 1980; Xavier Freixas, Roger Guesnerie and Jean Tirole, "Planning under Incomplete Information and the Ratchet Effect" 52 Rev. Econ. Studies (1985); and Jean-Jacques Laffont and Jean Tirole, "The Dynamics of Incentive Contracts" 56 Econometrica, 1988.

efficiency is compromised. The regulated firm will weigh and balance the increase in profits in the short run from investments in technology that lower costs with the likelihood that in the next period the cost-reducing investment will increase the yardstick by which performance is measured thus leading to lower profits in the short run. As recognized by the D.C. Court of Appeals in response to MCI's request to reinitialize the interstate X factor based on observed accounting earnings for interstate services:

> Universal, complete reinitialization would impair the supposed incentive advantages of price caps—which derive from firms' supposing that their efficiencies will not come back to haunt them.[54]

Thus, the course of action that is most consistent with avoiding the inefficiencies is for the regulator to credibly commit not to revise the plan in light of the information revealed through the company's performance.[55]

V. Conclusions

66. Data are just becoming available for the period in which Phase I and Phase II pricing flexibility was available in certain MSAs. A careful analysis of that data does *not* show that ILECs have been able to exercise market power. There has been no evidence presented that there have been significant and sustained increases in price associated with pricing flexibility. On the contrary, prices for services as well as average revenue per circuit have fallen steadily for special access services throughout the period. Nothing in the data suggests that the Commission reverse its decade-long commitment to pricing flexibility where market forces are adequate to constrain pricing.

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[54] U.S. Court of Appeals For the District of Columbia Circuit, United States Telephone Association, et. al., Petitioners . Federal Communications Commission and United States of America, Respondents, AT&T Corporation, et. al., Interveners, May 21, 1999 No. 97-1469.

[55] See David P. Baron and David Besanko, "Commitment and Fairness in a Dynamic Regulatory Relationship" Review of Economic Studies, 1987. As they state, "[Commitment] strikes the optimal balance between the marginal reduction in consumer surplus resulting from distorting price above marginal cost and the marginal reduction in rents resulting from that distortion…The ex ante reduction in welfare from fully exploiting this information always exceeds the ex ante increase in second-period surplus that would result from marginal-cost pricing."

67. While parties agree on little, there appears to be reasonable agreement and no articulated disagreement to permit ILECs to reduce rates by responding to RFPs and negotiate commercial agreements ubiquitously, irrespective of current trigger requirements. Regulators should always be wary of regulations that restrict price reductions generically, and permitting ILECs to reduce rates in this manner will increase consumer welfare without fostering anticompetitive pricing behavior.

TAYLOR ATTACHMENT 1.

SUMMARY OUTPUT Price per Mile = 0.1383 + 153.6216 × 1 / Miles						
Regression Statistics						
Multiple R	0.6106					
R Square	0.3728					
Adjusted R Square	0.2945					
Standard Error	0.0654					
Observations	10					
ANOVA						
	Df	*SS*	*MS*	*F*	*Significance F*	
Regression	1	0.0203	0.0204	4.7570	0.0608	
Residual	8	0.0343	0.0043			
Total	9	0.0547				
	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*
Intercept	0.1383	0.0491	2.8166	0.0226	0.0251	0.2515
1 / Mile	153.6216	70.4343	2.1811	0.0608	-8.8001	316.0433

Round-trip lowest price between BOS and SFO, LAX, ORD, DEN, SAN, SEA, LAS, ATL, MIA, and DFW.

TAYLOR ATTACHMENT 2
[BEGIN VERIZON PROPRIETARY]

[END VERIZON PROPRIETARY]				
Compound Annual Growth Rate: Real				
1999-2004	-6.57%	-1.64%	-5.87%	-4.59%
2002-2004	-5.49%	-5.11%	-3.09%	-6.18%
1999-2001	-7.22%	-2.42%	-11.59%	-4.63%
2001-2004	-6.14%	-1.12%	-1.85%	-4.56%

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on July 25 2005

William E. Taylor

RECEIVED

JUL 2 9 2005

Federal Communications Commission
Office of Secretary

REPLY COMMENTS OF VERIZON
WC DOCKET NO. 05-25
JULY 29, 2005

ATTACHMENT B

REPLY DECLARATION OF Q. LEW

REDACTED – FOR PUBLIC INSPECTION

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

RECEIVED

JUL 29 2005

Federal Communications Commission
Office of Secretary

In the Matter of	)	
	)	
Special Access Rates for Price Cap	)	
Local Exchange Carriers	)	WC Docket No. 05-25
	)	

REPLY DECLARATION OF QUINTIN LEW

1. My name is Quintin Lew. My business address is 1095 Avenue of the Americas, New York City, New York 10036. I am Vice President – Access Marketing in Verizon's Wholesale Markets Group and have worked at Verizon for 19 years. In this capacity, I am responsible for the marketing for our Special Access Products. I have nearly 20 years' experience with Verizon or its predecessors in most areas of marketing, strategic planning, and business development.

2. I previously submitted a declaration that was attached to Verizon's comments, filed on June 13, 2005. *See* Comments of Verizon, Attachment D, Declaration of Quintin Lew, Special Access Rates for Price Cap Local Exchange Carriers, WC Docket No. 05-25 (June 13, 2005) ("Lew Decl."). In that declaration, I demonstrated that: (1) there is robust competition in the provision of special access at the wholesale level; (2) Verizon's wholesale customers are using Verizon's special access services to compete successfully against Verizon in serving businesses of all shapes and sizes; (3) the pricing flexibility triggers not only accurately predict the existence of competition, but are significantly underinclusive; (4) special access competition

forces Verizon to be responsive to our wholesale customers' pricing demands; and (5) Verizon's multitude of special access plans respond to competition, are non-discriminatory, and reasonable.

3. The purpose of my reply declaration is to: (1) rebut claims that Verizon's term and volume plans are unreasonable and discriminatory, and not competitively disciplined; (2) show that the same parties who allege that the provision of special access services is not competitive have stated publicly that they are competing successfully in providing high capacity services; (3) describe the use of carrier hotels in Verizon's Territory; (4) refute allegations that Verizon makes it difficult for customers to move special access circuits to other providers; and (5) highlight examples of how the current rules frustrate Verizon's ability to respond to competition.

I. VERIZON'S TERM AND VOLUME PLANS ARE REASONABLE AND NON-DISCRIMINATORY.

A. Verizon's Plans Are Comparable to Those Offered by Its Competitors.

4. Certain parties allege that if special access services were competitive, ILECs' tariffs should include terms and conditions that match individual competitive carriers. *See e.g.*, Broadwing/SAVVIS 26-27. In particular, these commenters claim that (1) competitors "typically do not charge a termination penalty" if a circuit is terminated "before the term of the contract, ... so long as overall spend remains at or above the committed amount," whereas ILECs "require [customers] to commit to circuit-specific three-to-five year contracts," and (2) competitors "permit [companies] to commit to one-year contracts on a circuit-by-circuit basis," while ILECs supposedly require "three, five, or seven-year contracts that cover all of the special access circuits purchased within the ILEC's region." While there is no reason to expect competing providers to offer identical terms, in fact, on the particular issues highlighted, Verizon has offerings that are quite similar to the competitive carriers.

REDACTED – FOR PUBLIC INSPECTION

5. Indeed, Verizon East's Commitment Discount Plans and Verizon West's Term Volume Plans (two varieties of the many discount plans offered by Verizon) are extremely popular with our customers because such plans permit customers to terminate, add, and move circuits without liability, as long as the overall number of channel terminations remains at or above the committed amount and a line is not removed prior to expiration of the applicable minimum retention period (which is calculated from the time the circuit is installed, not from the time the customer subscribes to a plan). Under Verizon's DS1 Term and Volume Plan, carriers also select their commitment level and thus customers are free to put just a small portion of their traffic on these plans (or on Verizon's network) and still receive substantial discounts.

6. Verizon's Commitment Discount Plan and DS1 Term and Volume Plan are available in a range of terms, thus providing customers with the option that best suits their needs. The Commitment Discount Plan, for example, is available in terms of two, three, five, or seven years. And each special access service is available for different terms. Thus, a customer can subscribe to a three-year DS3 plan and a two-year DS1 plan. Verizon's DS1 Term and Volume Plan likewise is available in terms of one, two, three or five years.

7. And Verizon, just like its competitors, also offers circuit-specific discounts for as little as one-year term commitments (as well as for longer terms). *See generally* Lew Decl. ¶ 65. The terms and conditions in Verizon's discount plans reflect the intensity of special access competition.

8. The only concern expressed about Verizon's discount plans is that some plans require the customer to maintain for the term of the plan a volume level equivalent to 90 percent of the relevant circuits it had in service with Verizon at the beginning of the plan. *See* CompTel 19-20

(raising specific concerns about Verizon West's Eight and Ten Year Term Volume Plan ("ETTVP")), WilTel 15 (generally objecting to the 90 percent requirement in Verizon East's Commitment Discount Plan).

9. Both the ETTVP and the Commitment Discount Plan are entirely optional, since Verizon offers a wide range of other plans that do not have a minimum volume commitment yet contain comparable competitive discounts, such as the circuit-specific plans and the Term and Volume plans. In addition, both of these plans were developed in response to customer requests for more flexibility to drop, add, and move circuits without liability, and they are quite well-received for this very reason. Thus, the plans with a 90 percent commitment are just additional options available to customers. Customers are free to agree to such terms and conditions in exchange for additional flexibility and additional benefits, or they may select an alternative plan that does not have any commitment requirement.

10. CompTel claims that the ETTVP is exclusionary because this Plan requires the customer to commit 90 percent of its DS1 channel terminations then in-service with Verizon for 8 or 10 years, increases the required commitment if the customer's volume under the plan increases, and allegedly includes substantial shortfall charges. These aspects of the plan are not exclusionary.

11. First, this plan is just one of many options for DS1 discounts offered by Verizon. As noted above, Verizon also offers a number of shorter duration DS1 Term Volume Plans (which are available for terms of one, two, three, or five years), which contain none of the conditions that CompTel complains about yet still offer competitive discounts. The DS1 Term and Volume Plans permit the customer to establish whatever commitment level it wishes, regardless of how many lines it has in place with Verizon, and they do not raise the commitment level